Pension World

The Magazine for Plan Sponsors and Investment Managers/A Publication of Communication Channels, Inc.

InterFirst Invests with a Southwestern Flavor

1984 Retirement Equity Act Changes the Rules

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Cover: **A fanciful interpretation of Southwestern-style investing flavors our cover. Photo by Bill Coker. Our investment manager profile of InterFirst Bank Dallas and InterFirst Investment Management begins on page 32.**

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Perspective On Investments

More plans are addressing the real rate of return issue

A recent column suggested that once the liquidity and diversification requirements of an employee benefit plan portfolio have been assured, the next priority becomes *producing a real rate of return.* To outdistance the inflation rate, the portfolio must emphasize those classes of assets having inherent characteristics which best exploit the evolving price environment. After establishing the outlook for future price levels, strategic redeployment of the assets can be made to capitalize on cyclical returns from the classes which will far outweigh the returns from the specific security positions themselves.

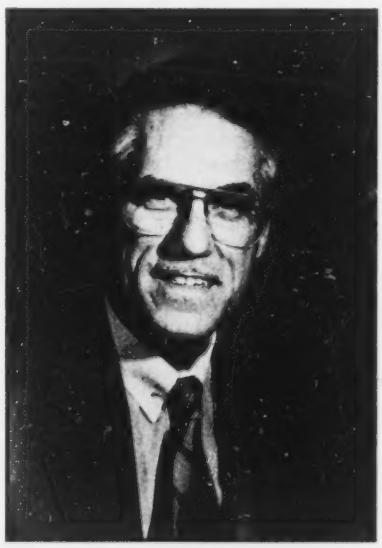
More and more plans are addressing the real rate of return issue. The rationale for adopting such an objective is reflected in the following paragraphs lifted from a plan's Statement of Investment Policy:

"To protect against unanticipated periods of hyperinflation, inflation, disinflation, and deflation, and the resultant disruption to orderly financial markets that these price changes cause, the pension plan portfolio is fully diversified.

"The portfolio includes both financial and tangible assets, actively and passively supervised, in varying allocations from time to time with the objective to add real value to the portfolio over time. The overall goal of the fund is to preserve capital and achieve capital enhancement measured on a real basis.

"As an investor in, and lender to, corporate America, it is deemed reasonable to expect that the portfolio over time should receive its fair share of the economy's real growth. Thus, the overall performance objective is to achieve a real rate of return over the long term that is comparable to the real growth in GNP, anticipated to approximate 3 percent per year."

Some years ago, Undersecretary of Treasury for Monetary Affairs, Dr. Beryl W. Sprinkel described in his book, *Winning With Money,* how the different classes of assets performed on a real basis in varying price environments. His research indicates that during periods of rising inflation, farmland, silver, housing and common stocks did well and commercial paper and bonds performed poorly. Conversely, during disinflationary periods, bonds and commercial paper did well, with farmland and silver performing poorly. In the hoped-for "Utopia" period of stable inflation, most classes do well, with common stocks outdistancing all others.



by **EUGENE B. BURROUGHS**
Director
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Washington, DC

The underlying reason that financial assets respond as they do to changing price levels is because the investment community prices them on the basis of the discounted present value of their future financial flows. The change in the discount rate is to a large measure influenced by the inflation rate. Thus as prices rise, including the cost of money (interest rates), a higher discount rate is used which lowers the present value of the underlying assets. This discounting mechanism affects common stock as well as fixed income securities. Tangible (nonmonetary) assets are also affected by changes in prices. Increased prices raise the cost of replacing those assets and decreased prices make possible the replacement of asset at a lower cost. Equity real estate as a class has characteristics which are both financial (leases) and tangible (bricks and mortar) in nature, permitting it, in general, to be relatively less volatile in price during inflation cycles.

When should the portfolio be tilted toward a preponderance of financial assets? When should tangible assets be emphasized? Robert Salomon, Jr., of Salomon Bros., believes factors favorable to increasing values in financial assets are increasing confidence in money (i.e., declining inflation rate), reduced government intervention in the private sector, sustained economic growth, improving productivity, political stability and an economy favoring savings and investment. Conversely, factors favorable to an increase in value in tangible assets are an escalating rate of inflation, rising taxes, increasing government regulation, political in-

stability, an economy favoring consumption and fear of personal harm.

In retrospect, then, it is no wonder the bond and stock markets rallied so significantly in the summer of 1982. All the necessary ingredients were in place to produce a favorable environment for financial assets. Belatedly, and in a show of "group think," the investing public realized that the trend of disinflation was well entrenched, "privatization" of economic activities was being legislatively and administratively promoted, the economy was improving, wage "give-ups" were taking place and savings incentives (IRA's, etc.) were being embraced by the consumer.

Conversely, are we now prospectively facing an environment which includes the factors favorable to an increase in value in tangible assets? Most would agree that inflation will accelerate and taxes will have to be raised to offset the budget deficit; some would suggest that deregulation has gone too far in certain industries and the economy may top out soon. Labor unions are getting restless after observing the recent rise in corporate profits and executive compensation, and the consumer feels better about personal spending due to the significant increase in the employment figures.

Hopefully, all of these trends will not converge simultaneously. Maybe this time we'll have a mixture of influences which will result in *both* financial assets *and* tangible assets performing relatively and moderately well.

Have the classes performed recently as the longer term historical experience would suggest? According to Salomon Bros., for the fifteen years ended May 31, 1984 (a period of relatively high inflation), returns from the various classes were as follows:

Rank	15 Years
1. Oil	20.4%
2. Coins	17.3
3. Gold	16.3
4. U.S. Stamps	16.1
5. Chinese Ceramics	13.7
6. Silver	11.7
7. Diamonds	10.4
8. Farmland	9.6
9. Treasury Bills	9.0
10. Old Masters	8.5
11. Housing	8.5
12. CPI (Consumer Price Index)	7.2
13. Bonds	5.7
14. Stocks	5.3
15. Foreign Exchange	3.0

Thus, true to historical experience, tangible (non-monetary) assets outperformed inflation, and financial assets underperformed the CPI.

The current phenomenon of high nominal interest rates *and* low inflation rates may be presenting a "window of opportunity" to investment portfolios that may be short-lived. With the high nominal rates possibly dampening the level of economic activity, and thus inflationary pressures, tax-exempt pools are enjoying the best of both worlds, i.e., high interest rates and low inflation rates. Perhaps it is simply the fixed income investor's turn to realize an acceptable real rate of return, since accomplishing this has been so elusive during the past decade.

Whatever the reasons for interest rates remaining so high in light of the lower inflation, it is obvious that the investing public is not overly tempted by any so-called "window of opportunity" of the relatively high real rates of current return. They are simply not buying it; maybe it's because they have looked over their shoulders at the past record of fixed income investing. Although the purchase of higher dividend stocks and well conceived, well located, well managed income-producing real estate has been an effective means to produce real rates of return, holding long-term fixed income securities has unfortunately extracted a real principal toll which has offset the value of clipping interest coupons. According to the Ibbotson/Sinquefield studies, for the fifty years ended December 31, 1983, long-term government bonds produced +3.3 percent per year, long-term corporate bonds +3.9 percent per year, while inflation averaged +4.2 percent per year. Thus, these classes produced negative real rates of return over the measured period. In fact, except for holding periods in the mid-thirties to early forties, mid-fifties to early sixties, and 1982-1983, it would have been difficult to produce any positive real rates of return by holding long-term governments. Thus, a review of the historical record causes analysis of the current period of extraordinarily high real rates of interest to question whether these rates represent a "once in a lifetime" buying opportunity, or just another bond market "bear trap." Maybe those who are hedging against an uncertain future through purchasing variable rate notes are taking the more prudent course.

In our search for value, we will always face the challenge of identifying those emerging actions which will most influence the prices of our portfolio holdings in the future. As managers of risk, we need to keep our eye on the rearview mirror, learning from the past, primarily for the purpose of evaluating the present, and constructively exploiting the future. Our perception of the evolving economic/political/social environment is important to the development of convictions about the future level of prices. Acting upon this conviction we can then, hopefully, tilt our portfolio toward investment success. In a subsequent column we shall discuss the "tilting process" and various ways we may add incremental return to the portfolio. Such return enhancement may just be enough to attain our quest for the elusive *real rate of return!* □

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